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In The

Supreme Court of the United States

DAVID A. and LOUISE A. GITLITZ;
PHILIP D. and ELEANOR G. WINN,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Writ Of Certiorari
To The United States Court Of Appeals
For The Tenth Circuit

BRIEF AMICUS CURIAE FOR THE REAL ESTATE ROUNDTABLE SUPPORTING PETITIONERS

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STATEMENT OF AMICUS INTEREST[1]

The Real Estate Roundtable (the "RER") is an organization comprised of the principals of the leading real estate companies and the heads of major real estate trade organizations. Its members are public and private real estate owners, advisors, builders, investors, lenders and managers. The RER provides a vehicle for its members to identify, develop, analyze and advocate federal policy positions.

The RER writes to urge the Court to reverse the decision of the Tenth Circuit concerning the tax treatment of cancellation of indebtedness (COD) income by an insolvent or bankrupt S corporation. Although the decision directly affects only a handful of the members of the RER (because most real estate is not owned through S corporations), the Tenth Circuit's erroneous interpretation and application of Section 108(b)(4)(A)[2] could have wide-ranging impact on the real estate industry.

Furthermore, the real estate industry is significantly affected by the tax laws, so that certainty as to application of the Code is essential. The Tenth Circuit's decision, which is contrary to the plain meaning of the Code, appears to be a strained attempt to re-write the statute to obtain what the court believes is the "right" result. The

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[1] The parties have consented to the filing of this brief. Counsel for a party did not author this brief in whole or in part. No person or entity, other than the *Amicus Curiae*, its members or its counsel, made a monetary contribution to the preparation and submission of this brief.

[2] Unless otherwise indicated, all Section references are to the Internal Revenue Code of 1986, as amended ("Code").

courts should not substitute their judgment for that of Congress; if the Code needs to be changed, Congress (and not the courts) should fix it. Accordingly, the RER urges the Court to adopt the analysis set forth by the Third and Eleventh Circuits in *U.S. v. Farley*, 202 F.3d 198 (3rd Cir. 2000), and *Pugh v. Commissioner*, No. 99-12646, 2000 U.S. App. LEXIS 12200 (11th Cir. 2000), respectively.

SUMMARY OF ARGUMENT

1. Section 108(b) of the Code provides for the reduction of tax attributes as a result of the exclusion of COD income under Section 108(a). Section 108(b)(4)(A) provides an essential "ordering" rule concerning the timing of attribute reduction. Under this provision, tax attributes are reduced *after* the determination of the tax liability for the year of the discharge of indebtedness. The Tenth Circuit disregarded this rule, reducing tax attributes *as part of* the determination of the tax liability for the year of the discharge of indebtedness.[3] There is no basis for the Tenth Circuit's application of this rule.

This timing rule is a critical element of every debt workout or restructuring. The ordering rule furthers sound tax and economic policies which should not be lightly brushed aside. Moreover, the Tenth Circuit's interpretation of this rule could have an impact far beyond the

[3] *See Gitlitz v. Commissioner*, 182 F.3d 1143 (10th Cir. 1999).

narrow question concerning the interaction of the rules involving COD income and S corporations currently before the Court.

2. The Code provides clear rules concerning the treatment of excluded COD income by an insolvent or bankrupt S corporation. The Tax Court in *Nelson v. Commissioner*, 110 T.C. 114 (1998), made a strained interpretation of the law in order to avoid a result that the Tax Court believed resulted in an unwarranted benefit to the taxpayer. But to do so, the Tax Court had to ignore the plain meaning of the Code.

No circuit court has agreed with the *Nelson* rationale because *Nelson* cannot be reconciled with the Code. Nonetheless, three circuit courts have held for the IRS. These courts have all explicitly recognized that theirs were result-oriented decisions, which were aimed at achieving the "right" result, even if the Code does not support their conclusions.

Taxpayers need certainty in the tax law, particularly when the law is clear. The tax law is written by Congress, not the courts. In this case, the clear language of the Code requires a decision in favor of the taxpayer, as two circuit courts have recognized in *Farley* and *Pugh*. The Court should reverse the decision of the Tenth Circuit for the reasons set forth by the Third and Eleventh Circuits.

BACKGROUND

The tax law is often obscure and confusing; the courts have frequently said as much.[4] That is not the problem in this case, however. In the case of COD income realized by an insolvent or bankrupt S corporation, the Code is clear. Although various sections of the Code are involved, the statutory path is a bright one, and all the provisions interact in a seamless web that results in predictable tax consequences.

S Corporations. S corporations are a creature of the Code, with special pass-through treatment ordained by Sections 1363, 1366 and 1367. Under Section 1363(a), an S corporation is not subject to income tax. Instead, Section 1366(a)(1)(A) provides that the shareholder of an S corporation is required, in determining his or her income tax liability, to take into account the shareholder's pro rata share of the S corporation's:

> items of income (including tax-exempt income), loss, deduction or credit the separate treatment of which could affect the liability for tax of any shareholder.

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[4] Judge Learned Hand once commented, "In my own case the words of such an act as the Income Tax, for example, merely dance before my eyes in a meaningless procession: cross-reference to cross-reference, exception upon exception – couched in abstract terms that offer no handle to seize hold of – leave in my mind only a confused sense of some vitally important, but successfully concealed purport, which it is my duty to extract, but which is within my power, if at all, only after the most inordinate expenditure of time." *The Spirit of Liberty: Papers and Addresses of Learned Hand* (Irving Dillard ed., 2d ed., 1953) 213.

Distributions by an S corporation to a shareholder are taxable to the extent that the distributions exceed the shareholder's stock basis.[5] Section 1367(a) provides a basis increase for every item described in Section 1366(a)(1)(A), *i.e.*, all items of income (including tax-exempt income). Thus, for example, if an S corporation receives interest on tax-exempt bonds (Section 103) or the proceeds of a life-insurance policy (Section 101), the shareholder's basis in the S corporation is increased by the amount of tax-exempt income.

Basis is also important to a shareholder of an S corporation in determining the amount of losses the shareholder can utilize. Under Section 1366(d), a shareholder of an S corporation may not utilize losses in excess of his or her basis in the stock of the S corporation; every dollar of loss utilized is treated as a distribution to the shareholder, reducing his or her stock basis.

COD Income. Subchapter B of Chapter 1 of the Code addresses the computation of taxable income of a taxpayer. Part I of Subchapter B, which is the definition of gross income, includes Section 61(a)(12), which sets forth the general rule that COD income is included in taxable income. Part III of Subchapter B, entitled "Items Specifically Excluded from Gross Income," contains 31 sections, each specifically providing an exclusion from gross income. Section 108 provides for the exclusion of COD income in certain situations.

Under Section 108(a), gross income does not include any amount which would otherwise be includible in

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[5] Section 1368.

gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if the discharge occurs when the taxpayer is insolvent or in a Title 11 bankruptcy case. The "price" for this discharge is that a taxpayer is required to reduce tax attributes (such as net operating loss carryovers, capital loss carryovers, the basis of assets and passive loss carryovers) by the amount of COD income that has been excluded.[6] This attribute reduction is made, pursuant to Section 108(b)(4)(A), after the determination of the tax imposed on the taxpayer for the taxable year of the discharge.

The ordering rule in Section 108(b)(4)(A) is important because it allows an insolvent or bankrupt taxpayer to fully utilize any tax attributes to offset any taxable income for the current year before reducing such attributes as a result of the exclusion of COD income. Thus, for example, if an insolvent individual has $100 of salary income, $150 of net operating loss carryovers ("NOLs") and $175 of COD income in 2000, the taxpayer would (i) exclude the COD income under Section 108(a), (ii) use $100 of the NOLs to offset his or her salary income in 2000, and then (iii) reduce his or her remaining tax attributes ($50 of NOLs) as a result of the exclusion of $175 of COD income.[7] The fact that the excluded COD income

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[6] Section 108(b).

[7] *See* S. Rep. No. 1035, 95th Cong. 2d Sess. 1, 13 n.13 (1980) ("These [attribute] reductions are made after the computation of the current year's tax.")

exceeded the taxpayer's tax attributes would have no further impact on the calculation of his tax liability.[8]

Special COD Rules for S Corporations. Congress addressed the interaction of Section 108 and Subchapter S corporations concisely in Section 108(d)(7). Specifically, Section 108(d)(7)(A) provides in relevant part that subsections 108(a) and 108(b) must be applied at the corporate level. Thus, in determining whether Section 108(a) applies to an S corporation, the solvency determination is made at the corporate (and not at the shareholder) level. This is the opposite of the rule for partnerships, in which the determination of solvency is made at the partner level.[9]

An S corporation does not have NOLs because an S corporation is not taxable on its income. However, losses of an S corporation can be suspended at the shareholder level (due to a lack of basis) under Section 1366(d). Section 108(d)(7)(B) coordinates the rules of Subchapter S with the attribute reduction rules in Section 108(b) by providing that for purposes of Section 108(b), any losses which are suspended under Section 1366(d) shall be treated as NOLs for the taxable year. The effect of this rule is to treat shareholder-level suspended losses as if they were corporate-level NOLs, which are then treated as attributes subject to reduction under the general rules in Section 108(b).

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[8] *See* S. Rep. No. 1035, 96th Cong., 2d Sess. 1, 13 (1980) ("Any amount of debt discharge which is left after attribute reduction under these rules is disregarded, *i.e.*, does not result in income or have other tax consequences.")

[9] Section 108(d)(6).

The Litigation. The tax treatment of S corporations realizing COD income was not raised by the IRS until the debt workouts that occurred in the early 1990s. At that time, many S corporations became either insolvent or filed for bankruptcy.

In a typical case (such as *Gitlitz*), the S corporation had indebtedness that significantly exceeded the fair market value of its assets. Losses realized at the S corporation level exceeded the shareholder's basis in the stock of the S corporation; such excess losses were suspended at the shareholder level under Section 1366(d). When all or a portion of the indebtedness was forgiven by the lender, it was undisputed that the COD income was excluded under Section 108(a) due to the insolvency of the S corporation. The shareholders of the corporations claimed that the excluded COD income resulted in a basis increase and, to the extent the shareholders had suspended losses under Section 1366(d), this basis increase permitted the shareholders to use those losses in the year of discharge. Attribute reduction would not occur until after the determination of tax liability for the year of discharge, so the suspended losses were used before attribute reduction could take place.

The questions considered by the courts in the instant series of cases were (i) whether the excluded COD income "flowed through" to the shareholder, thereby resulting in a basis increase under Section 1367(a), and (ii) if it did, could the shareholder utilize losses suspended under Section 1366(d) during the year of the discharge (and before

such losses could be reduced under Section 108(b)).[10] The various courts have, in chronological order, used differing reasoning and reached disparate results:

Nelson. The Tax Court was the first court to face this issue.[11] In *Nelson*, the Tax Court concluded that Section 108(d)(7)(A) required that the exclusion of COD income be made at the corporate level. Because COD income was excluded at that level, the Tax Court concluded that there was no income to pass through to the shareholders of the corporation. The Tax Court further reasoned that because the COD income had been eliminated at the corporate level, it was not tax-exempt income that could flow through to increase the shareholder's basis. Because there was no basis increase, suspended losses could not be utilized but, instead, were attributes that were treated as NOLs and reduced pursuant to Section 108(d)(7)(B).

The Tax Court's decision rested on its erroneous interpretation of the phrase "applied at the corporate level" in Section 108(d)(7)(A). In the case of an S corporation, all calculations of income, gain, deduction, loss and credit are first made at the corporate level, with items

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[10] The COD income would cause a basis increase under Section 1367, which would remove the restriction on loss utilization under Section 1366(d). As a result, the taxpayer could use suspended losses to offset income from the year of discharge, or carry such losses back to offset income in a prior taxable year. Because the losses had been utilized, Section 108(b) would be inapplicable.

[11] In its first foray into this area, *Winn v. Commissioner*, 75 T.C.M. (CCH) 1840 (1998), the Tax Court granted summary judgment for the taxpayer; the Tax Court reversed *Winn* in *Nelson*.

then passing through to the shareholders of the S corporation. Likewise, limitations provided in the Code, such as the limitation on the deduction of hobby losses under Section 183, are first applied at the corporate level. The fact that calculations and limitations are first applied at the corporate level does not prevent a flow-through to the shareholders of the S corporation; Section 1366(a) mandates the opposite result. In the case of COD income, the insolvency determination made at the corporate level results in exclusion of the COD income, with the excluded COD income then flowing through to the corporation's shareholders under Section 1366(a).

Gitlitz. In *Gitlitz*, the Tenth Circuit affirmed *Nelson* on other grounds. The Tenth Circuit (as well as every other circuit court) expressly rejected the Tax Court's conclusion that COD income was not tax exempt income that passes through to the shareholders of the S corporation. Instead, to prevent losses being claimed by the shareholders, the Tenth Circuit concluded that attribute reduction under Section 108(b)(4)(A) occurs during the year that the debt is cancelled. The court accomplished its goal by using the suspended losses to offset the COD income. The result was that the suspended losses were eliminated, thereby preventing the taxpayers from claiming losses during the taxable year at issue. Offsetting the COD income by the suspended losses also prevented a basis increase to the shareholders.

The Tenth Circuit referred to the "absorption" of the COD income or to "offsetting" the COD income with tax attributes. This analysis misapplies the statutory scheme. Under Section 108(a), the COD income of an insolvent or bankrupt S corporation is excluded, without any "offset"

or "absorption." If the S corporation has any tax attributes remaining after the calculation of tax for the year of the discharge, such attributes are reduced (up to the amount of the COD income) under Section 108(b). If the S corporation has no tax attributes, however, the COD income is nonetheless excluded under Section 108(a). Thus, the exclusion of COD income is independent of the tax attribute reduction.

The Tenth Circuit apparently recognized that its decision could not be reconciled under the statutory language in Section 108(b)(4)(A), and that its decision could have an impact on situations not involving S corporations. Accordingly, the Tenth Circuit stated in dicta that its application of Section 108(b)(4)(A) was limited to determining the impact of COD income on S corporations. *See* 182 F.3d at 1151. However, there is absolutely no statutory support for this limitation; neither Section 108(b)(4)(A) nor Section 108(d)(7) authorizes a special attribute reduction ordering rule applicable only to S corporations.

Witzel. In *Witzel v. Commissioner*, 200 F.3d 496 (7th Cir. 2000), the Seventh Circuit also rejected the analysis in *Nelson* and agreed with the Tenth Circuit's conclusion in *Gitlitz* that excluded COD income passed through to an S corporation's shareholders under Section 1366(a)(1)(A). Furthermore, the Seventh Circuit concluded that a shareholder is entitled to a basis increase for the excluded COD income under Section 1367(a). However, the Seventh Circuit also concluded that any suspended losses of the shareholder must be reduced by the amount of the excluded COD income under Section 108(b). The Seventh Circuit did not expressly indicate how this attribute

reduction occurs, but its decision can be rationalized if the suspended losses were reduced as part of the calculation of taxable income for the year of discharge, although the reduction of losses did not prevent a basis increase.

Farley. The Third Circuit, in *Farley*, was the first court to hold for the taxpayer. The Third Circuit applied the literal language of the Code, concluding that COD income is tax-exempt income that passes through to the S corporation's shareholders under Section 1366(a), resulting in a basis increase under Section 1367. This basis increase permitted the shareholders of the S corporation to utilize losses that had previously been suspended under Section 1366(d). Because Section 108(b)(4)(A) provides that attribute reduction does not occur until the commencement of the following taxable year, the suspended losses could not be reduced under Section 108(b) because they had been fully utilized during the year of the discharge. The court rejected all of the IRS' arguments because the statute clearly and unambiguously provided for the result claimed by the taxpayer.

Pugh. In *Pugh*, the Eleventh Circuit generally followed the approach taken by the Third Circuit in *Farley*. The Eleventh Circuit expressly held that excluded COD income passes through to the shareholders of the S corporation, resulting in a basis increase under Section 1367. Because the shareholders in *Pugh* had no suspended losses, attribute reduction was not an issue. The Eleventh Circuit emphasized that while Congress may not have intended this result, it was clear under the statute, and the Eleventh Circuit was leaving the re-writing of the Code to Congress.

Gaudiano. In *Gaudiano v. Commissioner,* No. 99-1294, 2000 U.S. App. LEXIS 12490 (6th Cir. 2000), the Sixth Circuit also concluded that excluded COD income passes through to the shareholders of an S corporation (thereby rejecting *Nelson)* and focused on the timing of attribute reduction. The court believed that there was a conflict between Sections 108(d)(7) and 108(b)(4)(A), resulting in a "close call" as to the timing of attribute reduction. The court was concerned that if attribute reduction occurs after the COD income passes through, then there might be no attributes left to reduce. The court further argued that although Section 108(b)(4)(A) provides that the reduction in tax attributes shall be made after the determination of the tax imposed for the taxable year of discharge, it did not prevent the reduction of some attributes in the year of discharge. As a result, the court concluded that suspended losses must offset any COD income, with any excess COD income passing through to the shareholder as a basis increase. The losses claimed by the taxpayer in the year at issue were denied, but losses would be possible in the future to the extent that excluded COD income exceeded current suspended losses.

ARGUMENT

1. TAX ATTRIBUTES OFFSET INCOME FOR THE YEAR OF THE DISCHARGE BEFORE SUCH ATTRIBUTES ARE REDUCED UNDER SECTION 108(b)

A. Tax Attribute Reduction is the Only "Cost" of the Exclusion for COD Income by an S Corporation

Section 108(a) provides for the exclusion of COD income by insolvent or bankrupt taxpayers. In the case of

an S corporation, this determination is made at the corporate level, *i.e.*, COD income is excludible if the S corporation (rather than its shareholders) is bankrupt or insolvent. The exclusion for COD income is not elective.

The Code exacts a price for the exclusion of COD income through attribute reduction under Section 108(b). Of course, attribute reduction occurs only if the taxpayer has any attributes to reduce. If an insolvent or bankrupt taxpayer has no tax attributes, the COD income is excluded under Section 108(a) but Section 108(b) has no impact.[12] In other words, COD income is always excluded by a bankrupt or insolvent taxpayer; the only "cost" to the taxpayer is attribute reduction, if the taxpayer has any tax attributes at the time the reduction occurs.

B. The Timing of Tax Attribute Reduction is Determined under Section 108(b)(4)(A)

As important as the conclusion that tax attributes are reduced is *when* such reduction occurs. Section 108(b)(4)(A) provides that tax attribute reduction occurs

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[12] The IRS argued in several of the cases below that Section 108(a) provides for a deferral, rather than an exclusion, of COD income because of tax attribute reduction under Section 108(b). That argument fails to take into account the situations in which a taxpayer has no tax attributes; in that case, there is no deferral, only exclusion. Furthermore, the IRS' argument ignores the word "could" in Section 1366(a)(1)(A); depending upon the circumstances of the shareholder, the excluded COD income *could* affect the determination of the shareholder's tax liability. The IRS conceded in *Farley* that the excluded COD income could be tax-exempt income. *See* 202 F.3d at 210.

"after the determination of the tax imposed by this chapter for the taxable year of the discharge." This plainly means that attributes are not reduced until after all of the tax consequences for the year of the discharge have been determined and taken into account. Thus, as a practical matter, tax attribute reduction occurs as of the first moment of the taxable year following the year of the discharge. This rule permits a taxpayer who has excluded COD income to utilize tax attributes to reduce his or her tax liability for the current taxable year (and, to the extent permitted under Section 172, to carry back any losses to prior taxable years) before such attributes are eliminated.

Two examples help illustrate this point. First, assume that an individual, Andy, owns an office building as a sole proprietor. Andy borrows $20,000 from a bank to meet the cash flow needs of his building and promptly spends (and deducts) all of the money, resulting in an NOL of $20,000. Andy is hopelessly insolvent because of other debts, and to avoid a useless collection action, the bank agrees in 2001 to discharge the debt. Simultaneously, to support himself, Andy gets a job as a waiter, earning $15,000 in 2001. The application of Section 108 is clear in Andy's situation. The COD income of $20,000 is excluded under Section 108(a). Andy uses the NOL of $20,000 to offset his salary income, which otherwise would have been taxable income for the year of discharge. After Andy's tax liability for the taxable year of the discharge has been determined, the remaining NOLs ($5,000) are eliminated under Section 108(b).

The same analysis would apply if the taxpayer were a C corporation. Assume that Bigco, which is involved in real estate development, borrows $100 million to finance

an office project. Bigco incurs large losses from depreciation and interest, resulting in $13 million of NOLs. The following year, Bigco provides leasing and management services to other companies, earning fees of $11 million, but because of its debt, Bigco is hopelessly insolvent, causing the lender to forgive $15 million of the loan. The tax consequences are clear: Bigco would exclude the COD income, and Bigco could use $11 million of NOLs to offset its services income. The remaining $2 million of NOLs would be eliminated under Section 108(b). If Bigco had any other tax attributes (such as basis in property, provided that the debt that encumbers the property does not exceed the amount of such basis), such other attributes would then be reduced.

The timing of tax attribute reduction is an important facet of the statutory scheme that applies to all taxpayers. Congress wanted to make certain that bankrupt or insolvent taxpayers could fully utilize their tax attributes to offset any income for the year of the discharge. Without this provision, an insolvent or bankrupt taxpayer could owe income tax that the taxpayer lacked the financial resources to pay. The ordering rule in Section 108(b)(4)(A) promotes the "fresh start" policy that underpins the income exclusion in Section 108 by allowing the insolvent or bankrupt taxpayer to utilize tax attributes to fullest extent possible before reducing them under Section 108(b).[13] Congress consciously allowed taxpayers to

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[13] *See* The Bankruptcy Tax Act of 1980: Hearings Before the Subcommittee on Select Revenue Measures of the House Ways and Means Committee, Statement of Daniel I. Halerin, Deputy Assistant Secretary of the Treasury for Tax Legislation, 96th Cong., 1st Sess. 3 (Sept. 27, 1979). Mr. Halperin stated that:

utilize their tax attributes to the maximum extent possible before reducing them as a result of the exclusion of COD income.

C. The Sixth, Seventh and Tenth Circuits Erroneously Interpreted or Ignored Section 108(b)(4)(A)

The fundamental flaw in the circuit courts' decisions in *Gitlitz*, *Witzel* and *Gaudiano* is the disregard of the ordering rule in Section 108(b)(4)(A). All these courts concluded that COD income of an insolvent or bankrupt S corporation that is exempt under Section 108(a) flows through to the corporation's shareholders, as required by Section 1366(a)(1)(A). However, the courts apparently did not want to allow the taxpayer to obtain all of the benefit of the basis increase that Section 1367(a) requires. Accordingly, the courts mandated attribute reduction by altering or ignoring the ordering rule in Section 108(b)(4)(A).[14]

> We are sympathetic to the basic policy of bankruptcy and would not want to discourage creditors from forgiving part of a debtor's debt by creating a tax liability that might be collectible before the amounts owing to forgiving creditors. Accordingly, we agree with the position taken in [the Bankruptcy Tax Act of 1980] that no taxpayer in bankruptcy, and no taxpayer who is insolvent after a debt is forgiven, should incur a tax liability as a result of forgiveness of indebtedness.

[14] The courts were not completely clear in how this attribute reduction would occur. In *Gitlitz* it appears that the Tenth Circuit used the suspended losses to offset COD income, which does not make any sense because the COD income was excluded by operation of Section 108(a). In *Witzel*, the Seventh

The disregard of Section 108(b)(4)(A) in *Gitlitz*, *Witzel* and *Gaudiano* is the RER's primary concern in this case. The courts that have supported the IRS have all (with the exception of the Tax Court in *Nelson*) issued result-oriented decisions that have misapplied Section 108(b)(4)(A). This creates a significant problem in applying Section 108(b)(4)(A) in the context of debt workouts not involving S corporations.

Every debt workout in which there is attribute reduction involves Section 108(b)(4)(A). This timing rule permits insolvent and bankrupt taxpayers to use their tax attributes in order to avoid having to go even further in debt to pay a tax on their taxable income in the year of the discharge, and also permits the attributes to be carried back to offset income in prior taxable years before reduction under Section 108(b).[15] Any deterioration of this rule will increase the tax burden on debt workouts, making them more difficult to achieve.

Moreover, there is no good argument to the contrary. The Sixth Circuit strained to find a way around the plain meaning of Section 108(b)(4)(A) in *Gaudiano*, arguing that such provision does not preclude the reduction of certain attributes in the year of the discharge. But that argument

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Circuit also agreed to offset the suspended losses against the COD income in order to avoid a "windfall" to the taxpayer. *See* 200 F.3d at 497. The Sixth Circuit was explicit in *Gaudiano*, stating that it was requiring the taxpayer to reduce some of its tax attributes (suspended losses) in the year of the discharge.

[15] Myron Sheinfeld, Fred T. Witt, Jr. and Milton Hyman, *Collier on Bankruptcy Taxation* ¶ TX6.03[2][b] (Matthew Bender, 1999).

completely disregards the word "after." If credence is given to the statute as written, there is no sound argument that attribute reduction occurs at any time other than *after* the taxable year of the discharge, *i.e.*, at the first moment of the succeeding taxable year.

The Sixth Circuit's argument, as well as that of the Tenth Circuit in *Gitlitz*, also ignored Section 1017, which is the provision giving effect to the basis reduction mandated under Section 108(b). Section 1017 clearly states that the attribute reduction is made as of the first moment of the taxable year following the year of discharge of the indebtedness. This provision, which was added to the Code at the same time as Section 108(b)(4)(A), clearly shows that Congress intended attribute reduction to occur *after* the year of discharge.

D. The Third and Eleventh Circuits Correctly Applied Section 108(b)(4)(A)

The circuit courts that held for the taxpayers have correctly held that attribute reduction occurs as of the first moment in the year following the year in which the debt cancellation occurs. As a result, the taxpayers were able to utilize suspended losses before attribute reduction occurred. This may result in a benefit to the taxpayers because suspended losses can be used before they are reduced. But it is a benefit that Congress specifically mandated – tax attributes are reduced only AFTER an insolvent or bankrupt taxpayer has determined its tax liability for the year of discharge.

It must be emphasized that the timing of attribute reduction under Section 108(b)(4)(A) does not always

result in a benefit to the shareholder of an S corporation. If the shareholder's suspended losses exceed the amount of excluded COD income, the shareholder will always suffer a detriment. For example, assume that John owns 100% of the stock of an insolvent S corporation that has borrowed and lost $1 million. As a result of these debt-financed losses, John has suspended losses under Section 1366(d) of $1 million. The lender to the corporation forgives $600,000 of the debt. The $600,000 of COD income will result in a basis increase of $600,000, allowing John to utilize that portion of his suspended losses. His remaining suspended losses ($400,000) would be eliminated, however, due to the attribute reduction that occurs as of the first moment of the succeeding taxable year.[16]

The RER believes, for the reasons set forth below, that the taxpayers should prevail in this case. But no matter how this Court rules in determining the tax consequences of excluded COD income to an S corporation, we urge the Court not to cast doubt upon the vitality of the ordering rule in Section 108(b)(4)(A).

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[16] From a mathematical perspective, (i) there will always be attribute reduction to some extent if the suspended losses of the S corporation shareholder exceed the amount of the debt that is discharged, and (ii) if the suspended losses are at least two times the amount of discharged debt, there will always be a full, dollar-for-dollar attribute reduction. In addition, attribute reduction will have an impact if the S corporation has any other tax attributes, such as basis, that could be reduced.

2. THE TAXPAYERS SHOULD PREVAIL UNDER THE PLAIN MEANING OF THE APPLICABLE STATUTORY PROVISIONS

A. The Applicable Law is Clear

The tax law can be obscure and confusing. In this case, however, the applicable provisions are relatively clear and straight-forward. The Code provides that (i) COD income is excluded by an insolvent or bankrupt S corporation under Section 108(a), (ii) the excluded COD income is an item of income to the shareholders of the S corporation under Section 1366(a)(1)(A) because it could affect the calculation of their tax liability,[17] (iii) all items of income under Section 1366(a)(1)(A) result in a basis increase under Section 1367(a), (iv) the increased basis permits a shareholder to utilize in the year of the discharge any losses that were previously suspended due to the basis limitation in Section 1366(d), and (v) attribute reduction (which could reduce the amount of suspended losses) does not occur until the first moment of the following taxable year under Section 108(b)(4)(A).

These rules are plain and indisputable. There is no ambiguity in the Code. Tax-exempt income includes all COD income, just as it includes all other items of income described in Part III of Subchapter B of Chapter 1 of the Code. Likewise, the pass-through of items of tax-exempt income to the shareholders of an S corporation, and the basis increase for such items of income, is mandated by

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[17] The excluded COD income would, for example, result in attribute reduction to any S corporation shareholder who had suspended losses in excess of the amount of COD income.

the express statutory language. So is the timing of attribute reduction.

If the language of the statute is plain, then the Court is obligated to enforce it according to its terms. *See Caminetti v. U.S.*, 242 U.S. 470 (1917). This fundamental principle of statutory interpretation is at the heart of this case. If this Court concludes that the statutory language is clear – and we believe that it is – the fact that the Code leads to what the IRS believes is not the "right" result is meaningless. If the IRS believes that the result should be different, then the IRS should look to Congress, not to the courts, for recourse.

B. The Applicable Law Has Always Been Clear

What makes this case particularly frustrating is not only that the language of the Code is clear, but also that taxpayers and their creditors knew what the Code said and what it meant and applied it on that basis. Numerous commentators have considered how these provisions work, and they have nearly universally reached the same conclusion – the law clearly supports the taxpayers' position.[18] Likewise, in the early 1990s, in connection with the

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[18] Commentaries that stated tax attribute reductions are to be made in the year following discharge include: Sheinfeld, Witt & Hyman, *supra* note 15, ¶ 6.03[4][b][i], at 6-103; Bryan P. Collins & Mark A. Schneider, *"TAM 9423007: The IRS Says Excluded COD Income Does Not Increase S Corporation Stock Basis,"* 6 J.S. Corporation Tax'n 348 (Spring 1995); Richard M. Lipton, *The Impact of Excluded COD Income on S Shareholders – The Tenth Circuit Gets Lost in Gitlitz*, 91 J. Tax'n 197 (October 1999); James D. Lockhart and James E. Duffy, *Tax Court Rules In Nelson That S*

debt workouts that were sweeping the country, the American Bar Association Section of Taxation formed a task force to describe current law concerning debt workouts and, where necessary, provide guidance concerning the possible application of the law where it was not clear. The ABA Task Force Report concluded that the applicable law was clear, while indicating that a minority of the members of the Task Force believed that a legislative change was appropriate.[19] This report was submitted to the IRS in July 1992.

Moreover, Congress was aware of the interaction of these provisions of the Code. This is proven by the legislative history to Section 108(a)(1)(D), which was enacted in 1993.[20] This provision allows the exclusion of COD income with respect to qualified real property indebtedness. Congress was concerned that such COD income could result in a basis increase for S corporations under the plain language of the Code. To prevent this result, the legislative history to the 1993 Act expressly provides that

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Corporation Excluded COD Income Does Not Increase Shareholder Stock Basis, 25 Wm. Mitchell L. Rev. 287, 310 (1999); Fred T. Witt, Jr. & William H. Lyons, *An Examination of the Tax Consequences of Discharge of Indebtedness*, 10 VA. Tax Rev. 1, 46-47 (1990). Commentaries that stated tax attribute reductions are to be made in the year of discharge include: C. Richard McQueen and Jack F. Williams, *Tax Aspects of Bankruptcy Law and Practice* § 25:6, at 25-6 (3d ed. 1997).

[19] Fred T. Witt, Jr., *Report of the Section 108 Real Estate and Partnership Task Force*, 46 Tax Law. 209, 234-35 (1992). This report was published before any of the cases at issue were decided, as well as before the enactment of Section 108(a)(1)(D), discussed below.

[20] Revenue Reconciliation Act of 1993 (the "1993 Act").

there is no basis increase in an S corporation for COD income from qualified real property business indebtedness. However, Congress enacted this special rule for qualified real property business indebtedness, and no change was made to the treatment of COD income of an insolvent or bankrupt S corporation. As the Third Circuit recognized in *Farley*, the 1993 Act does not support the IRS' position that excluded COD income does not affect the basis in the stock of an S corporation. Indeed, because Congress failed to change the applicable provisions in Sections 108, 1366 and 1367 of the Code, it could be inferred that Congress was endorsing the long-standing interpretation of these provisions while requiring a different result for COD income relating to real property business indebtedness.[21]

The clear statutory language results in a basis increase for excluded COD income by an insolvent or bankrupt S corporation. The result could be viewed as an appropriate tax benefit for the shareholder of an insolvent corporation, or it could be viewed as an untoward benefit to the shareholders of an insolvent S corporation. No matter which result is viewed as "right," however, the law remains clear.

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[21] "Where Congress adopts a new law incorporating sections of a prior law, Congress normally can be presumed to have had knowledge of the interpretation given to the incorporated law, at least in so far as it affects the new statute." *Lindahl v. Office of Personnel Management*, 470 U.S. 768, 783 (1985).

C. The Courts Have Disregarded Clear Law to Hold for the IRS

Each court that has found in favor of the IRS in this case has had to disregard or ignore the plain meaning of the statute in order to do so. The Tax Court did this in *Nelson* when it concluded that COD income does not pass through to the shareholders of an S corporation, notwithstanding the clear language to such effect in Section 1366(a)(1)(A). No circuit court has agreed with this analysis – even the three circuit courts that have held for the IRS have rejected the Tax Court's interpretation of Section 1366(a)(1)(A). The *Nelson* decision is difficult to support because the exclusion for COD income under Section 108 is worded exactly the same as the exclusion for other items of gross income under Part III of Subchapter B of Chapter 1 of the Code, which the IRS agrees result in a basis increase for an S corporation shareholder.[22] There is no statutory support for treating COD income different than other items of tax-exempt income.

Moreover, as discussed in detail above, the three circuits that have held for the IRS have erroneously applied Section 108(b)(4)(A) in order to reduce tax attributes. Once these courts concluded that COD income is an item of tax-exempt income that flows through to the shareholders of an insolvent S corporation, the application of the rules became automatic and irrefutable: (a) the shareholders' basis is increased by the COD income, (b)

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[22] Each section in Part III of Subchapter B of Chapter 1 of the Code, including Section 108, begins with the language "Except as otherwise provided, gross income does not include . . . "

the basis increase permits the utilization of losses previously suspended under Section 1366(d), and (c) any remaining tax attributes are reduced as of the first moment of the following taxable year. The Sixth, Seventh and Tenth Circuits attempted to avoid this result by requiring tax attribute reduction, even though the Code provides no support for their position.

D. *Farley* and *Pugh* Correctly Applied the Clear Law

The Third and Eleventh Circuits did not labor under the burdens facing the courts that wanted to hold for the IRS. In *Farley* and *Pugh*, the circuit courts simply enforced the statute as they found it.

Both circuit courts recognized that the result was beneficial to the taxpayer; some persons have even called the result a "windfall."[23] Whether or not this result should be viewed as a windful is debatable.[24] On the

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[23] Commentaries that have not viewed the basis increase and utilization of suspended losses as a windfall include: Richard M. Lipton, *Different Courts Adopt Different Approaches to the Impact of COD Income on S Corporations*, 92 J. Tax'n 207 (April 2000); Sheinfeld, Witt & Hyman, *supra* note 15, ¶ 6.03[4][b][i], at 6-103. Commentaries that have viewed the basis increase and utilization of suspended losses as a windfall include: McQueen, *supra* note 18.

[24] The taxpayers' position essentially results in allowing the taxpayer to utilize debt-financed deductions without any obligation to pay back the indebtedness. This result also occurs every time an individual taxpayer borrows money, uses debt-financed losses to offset his/her taxable income from other sources, and then fails to pay back the debt due to insolvency or

other hand, the tax benefit is obtained only because there has been a substantial economic loss, as reflected by the insolvency or bankruptcy of the S corporation. Thus, the supposed tax benefit is available only if the shareholder has suffered a large economic loss. This is the type of rational determination that Congress could have made (although there is no meaningful legislative history concerning Congress' intent in enacting these rules).

The RER does not believe that it is useful or worthwhile in this case to get into a debate concerning what is a "right" or "wrong" result in this situation, because there are arguments on both sides of the coin. What the RER believes is indisputable, however, is that the applicable law is clear. As discussed above, there is no way to interpret the statutory provisions other than (i) COD income of an insolvent or bankrupt S corporation is exempt under Section 108(a), (ii) the exempt COD income passes through to the shareholders of the S corporation under Section 1366(a)(1)(A), (iii) the shareholder's stock basis is increased under Section 1367(a) by all items described in Section 1366(a)(1)(A), (iv) the basis increase allows the shareholder to use losses that previously were suspended under Section 1366(d), and (v) although the suspended losses are treated as NOLs for purposes of applying the attribute reduction rules in Section 108(b), such attribute reduction does not occur until the first moment of the following taxable year under Section 108(b)(4)(A).

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bankruptcy. Thus, it is far from clear that there is a windfall when this benefit is available in the S corporation context, because S corporations have individual shareholders.

E. The Tax Law Requires Certainty

Taxation is one of the few areas of the law that affects almost every person in the United States. Every individual, and every business, must comply with the tax law. Creditors and taxpayers alike require certainty in the context of a debt workout or bankruptcy. And the tax laws are very complex.

Compliance with the tax law is a major concern in the real estate industry. Moreover, there are many provisions of the tax law that provide beneficial treatment to real estate.[25] Needless to say, it would be difficult for the real estate industry to plan for the tax consequences of their transactions if the clear result under the Code could be undermined because the IRS did not like the answer.

This case clearly illustrates the problem. As discussed above, the rules concerning the tax treatment of COD income by insolvent S corporations are clear, and the result has been known (and widely publicized) for many years. This is about as "certain" as one can get in the tax arena. This type of certainty should be furthered, not undercut, by the courts.

F. Application of the Plain Meaning of the Code Requires a Decision for the Taxpayers

The rules of statutory construction obligate this Court to apply the plain meaning of the statute, and not to resort to trying to determine what is the "right" or

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[25] *See, e.g.*, Section 1031, Section 121, Section 25, Section 42, Section 856, Section 857.

"wrong" answer, when the statutory provisions are clear. As the Third and Eleventh Circuits have recognized, the plain meaning of the statute results in a decision for the taxpayers in this situation. The result may not be pretty – the taxpayers get a benefit that Congress may or may not have intended – but it is clearly the result under the statutory language. The tax benefit arises, however, because of an economic loss that the taxpayer has suffered. Any other result runs contrary to long-standing rules of statutory construction and should be avoided by this Court.

CONCLUSION

Wherefore, the RER prays that this Court issue a decision reversing the decision of the Tenth Circuit in *Gitlitz* and requiring that decision be entered in favor of the taxpayers for the reasons set forth by the Third Circuit and the Eleventh Circuit in *Farley* and *Pugh*, respectively.

Respectfully submitted,

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